No. 82-1369

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

WESTERN COAL TRAFFIC LEAGUE, THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE, AMERICAN PAPER INSTITUTE, INC., CENTRAL ILLINOIS LIGHT COMPANY, MIDDLE SOUTH UTILITIES SYSTEM, POTOMAC ELECTRIC POWER COMPANY, PUBLIC SERVICE COMPANY OF INDIANA, INC., SOUTH CAROLINA PUBLIC SERVICE AUTHORITY, NEVADA POWER COMPANY, AND AMERICAN IRON AND STEEL INSTITUTE,

Petitioners,

v.

UNITED STATES OF AMERICA AND INTERSTATE COMMERCE COMMISSION,

Respondents.

PETITIONERS' REPLY TO BRIEFS OF RESPONDENTS IN OPPOSITION TO THE PETITION FOR WRIT OF CERTIORARI

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Table of Authorities Continued

INTRODUCTION

The Federal Respondents (the United States of America and the Interstate Commerce Commission) and the Association of American Railroads (the "Railroads") have filed briefs urging that the Petition For Writ of Certiorari be denied. These parties take the position that the Petition is not worthy of this Court's review because the issues raised are insubstantial and were correctly decided on their merits by the Court of Appeals. Petitioners file this brief in reply.

I

THE CRITICAL IMPORTANCE OF THE ISSUES RAISED BY PETITIONERS IS IGNORED BY THE RESPONDENTS

The ICC's *Ex Parte No. 393* decision holds that rail carriers are "revenue adequate" within the meaning of Section 10704(a)(2) only if their rate of return on historic net investment is equal to the current cost of capital. Using this standard as the sole measure of carrier revenue needs, the industry annually falls billions of dollars short of the sum it needs to be revenue adequate. According to the ICC's most recent pronouncements, the multi-billion dollar shortfall is to be recouped from rail traffic over which the carriers possess "market dominance," i.e. from shippers who have no competitive alternatives to rail service in moving their freight:

> [M]aximum rates on market dominant traffic, in general, should be permitted to increase to the extent necessary for a carrier to achieve revenue adequacy.[1]

Through its *Ex Parte No. 393* decision, the ICC has created a huge, phantom rail cash shortage which it proposes to have captive shippers remedy by paying massive freight rate increases on individual movements. In light of its intended consequences, *Ex Parte No. 393* is undeniably one of the most significant decisions ever issued by the Commission.

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[1] Ex Parte No. 347 (Sub No. 1), *Coal Rate Guidelines, Nationwide*, at sheet 15 (Decision served Feb. 24, 1983) (unprinted).

Despite the critical importance of *Ex Parte No. 393*, Federal Respondents attempt to downplay this case as one involving definitional semantics. (Brief at 8). Similarly, the Railroads say that the Petitioners' case rests on "economic technicalities." (Brief at 6). While Petitioners totally disagree with the Respondents' characterization, the point to be made here is that the ICC has stated its intent to use its *Ex Parte No. 393* findings to justify wholesale rate increases on captive rail traffic. Thus, rail shippers are not presenting a petition that has only technical or semantic appeal, but are in fact presenting one which raises questions of fundamental importance to the shipping public.[2]

Respondents maintain that shippers should pursue their interests in maximum reasonable rates through individual rate

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[2] In their briefs, Respondents continually attempt to create the illusion that the Interstate Commerce Act ("Act") and the 1976 and 1980 amendments to it, are solely concerned with railroad revenue needs. However, Congress has been equally concerned with protecting the public from rate exploitation by market dominant rail carriers. In the Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31 ("4-R Act"), Congress required the ICC to take care to ensure that rail rates on captive, market dominant traffic "balance the needs of carriers, shippers and the public." *Id.* § 101(b) (uncodified). In the Staggers Rail Act of 1980, Pub. L. No. 94-448, 94 Stat. 1895 (1980) ("Staggers Act") Congress cited the need for similar balancing. *Id.* § 3 (uncodified).

Based upon the consumer protection standards that lie at the heart of the Act, both this Court and the appellate courts have consistently ruled that carrier revenue needs must be balanced against shippers' rights to be free from monopoly exploitation in determining rate reasonableness under the Act. *See, e.g.*, *Ayrshire Collieries Corp.* v. *United States*, 335 U.S. 573, 592 (1949); *Burlington Northern, Inc.* v. *United States*, 661 F.2d 964, 973 (D.C. Cir. 1981); *Cleveland-Cliffs Iron Co.* v. *ICC*, 664 F.2d 568, 587 (6th Cir. 1981); *Iowa Public Service Co.* v. *ICC*, 643 F.2d 542, 548 (8th Cir. 1981); *Union Pacific R.R.* v. *United States*, 637 F.2d 764, 767 (10th Cir. 1981); *Celanese Chemical Co.* v. *United States*, 632 F.2d 568, 577 (5th Cir. 1981).

cases, and that therefore shippers' concerns are not worthy of consideration by this Court. Such arguments ignore reality. The existence and magnitude of the multibillion dollar carrier revenue shortfall is a direct product of the ICC's misconstruction of Section 10704(a)(2) and, if that misconstruction is not addressed here, it will continue to infect every ICC maximum ratemaking proceeding under the Act. Review by this Court is urgently required to correct this momentous and far-reaching error.

II

RESPONDENTS' ARGUMENTS DEFENDING THE ICC'S CONSEQUENTIAL "SINGLE STANDARD" INTERPRETATION OF SECTION 10704(a)(2) ARE WITHOUT MERIT

Respondents defend the ICC's construction of Section 10704(a)(2) as consistent with Congressional intent and the strictures of administrative decisionmaking set forth by this Court in *Atchison, Topeka & Santa Fe Ry.* v. *Wichita Board of Trade*, 412 U.S. 800 (1973) (*"Wichita Board"*), and related decisions. Each of these arguments is incorrect.

1. Federal Respondents admit that Section 10704(a)(2) "lists several performance tests" to be considered in determining whether a rail carrier is revenue adequate. They further concede that the legislative history of Section 10704(a)(2), as authoritatively construed by the United States Court of Appeals for the District of Columbia Circuit in *San Antonio, Texas* v. *United States*, 631 F.2d 831, 850 (D.C. Cir. 1980), "indicates that the Commission should not focus solely on rate-of-return analysis." (Brief at 13). Nevertheless, Respondents maintain that the ICC was correct to rely solely on a rate of return standard, despite the fact that "focus[ing] solely on a rate of return analysis" generates billions of capital shortfall dollars that simply do not exist when the agency carefully weighs all of the "several performance tests" set forth in Section 10704(a)(2), as it did prior to the issuance of its *Ex Parte No. 393* decision.

Respondents justify the ICC's reliance on a "single" performance test on grounds that the single standard adopted—a rate of return on a net investment base equal to the current cost of capital—generates a revenue need dollar amount that is larger than the amounts that other performance criteria produce. Accordingly, "a rate-of-return standard would assure sufficient income to meet those criteria." (Brief at 13).

Respondents' analysis, which simply parrots the position enunciated by the ICC in *Ex Parte No. 393* and deferred to by the Court of Appeals on review, ignores the fact that Congress did not want the ICC to rely solely on a rate of return standard precisely because such reliance could produce bloated revenue adequacy figures "that may have no relationship to the need for operating and capital funds necessary to maintain service in the public interest." S. Rep. No. 94-499, 94th Cong. 2d Sess. 52 (1975). Congress intended for the ICC to weigh all the performance criteria and to reach reasoned results, "as opposed to [setting] a theoretically adequate rate of return on investment." *Id.*

2. Consistent with the Congressional intent underlying Section 10704(a)(2), the ICC ruled in its first two implementing decisions under Section 10704(a)(2) that Congress "does not envision that the rate of return will be the sole factor to be considered in judging carrier revenue adequacy." Ex Parte No. 338, *Standards and Procedures for the Establishment of Adequate Revenue Levels*, 358 I.C.C. 844, 904 (1978); Ex Parte No. 353, *Adequacy of Railroad Revenue (1978 Determination)*, 362 I.C.C. 198, 216 (1979). In direct contravention of the principles enunciated by the Court in *Wichita Board*, the Commission's *Ex Parte No. 393* decision never addresses or explains its change of statutory interpretation.

Respondents argue that the Commission did not run afoul of *Wichita Board* because the ICC did provide the required explanation, in a passage of the *Ex Parte No. 393* decision which states that the ICC's "adoption of a rate of return standard is not a radical departure from our previous standards[]" because

"[i]n adopting such a standard here, we are only adapting our earlier findings to the mandate and policy of the [Staggers] Rail Act." (Federal Respondents' Brief at 14, quoting *Ex Parte No. 353, supra*).

The purported "explanation" by Respondents is no explanation at all. In fact, the passage cited by Respondents was not inserted by the ICC to address its previous statutory construction, but to ignore it by claiming there was no "radical departure" from its past standards. Of course, the agency's characterization is wrong. Under its pre-*Ex Parte No. 393* standards, where the agency looked to all relevant financial evidence, the ICC found that 13 of 31 major railroads in the United States were "revenue adequate." In contrast, when the ICC relied solely on its rate of return standard in *Ex Parte No. 393*, all but three roads were declared revenue inadequate and the revenue shortfall of the industry, as a whole, reached the astoundingly high level it stands at today. (Using post-*Ex Parte No. 393* capital costs, *no* roads are revenue adequate.) Thus, a "radical change" did, in fact, take place even though during this same time period the financial health of the rail industry actually improved.

Similarly, the Commission's cryptic reference to the Staggers Act does not supply the reasoned basis required under *Wichita Board* for its new statutory interpretation. In the Staggers Act, the Congress left the definition of revenue adequacy unchanged.[3] Nothing in the Staggers Act, or its legislative history, supports the ICC's new construction of

[3] While leaving the definition of carrier revenue adequacy unchanged, Congress codified the ICC's pre-Staggers Act practice of considering revenue adequacy in rate reasonableness cases (*id.* §§ 201(a), 203(a), *codified in pertinent part* at 49 U.S.C. §§ 10701(a)(b)(3), 10707a(d)), ordered the ICC to finish its incomplete revenue adequacy proceedings (Staggers Act § 205, codified at 49 U.S.C. § 10704(a)(3) and (4)), and inserted a clause in the statute authorizing the ICC to "revise as necessary" its then-current reve-

10704(a)(2). Indeed, while Congress made numerous changes in other sections of the Act, its decision not to change Section 10704(a)(2), as administered by the ICC prior to the Staggers Act, provides compelling proof that Congress accepted and adopted the ICC's initial reading. *Cf. Goldsboro Christian Schools, Inc.* v. *United States*, ___ U.S. ___, No. 81-1 (S.Ct. May 24, 1983) (slip op.).

III

RESPONDENTS' OTHER ARGUMENTS UNDERSCORE THE PLIGHT OF THE NATION'S CAPTIVE RAIL SHIPPERS AND THE NEED FOR REVIEW BY THIS COURT

In its *Ex Parte No. 393* decision, the ICC further compounded its error in adopting a rate base/rate of return standard by designing a standard whose only apparent justification is that it creates an enormous revenue shortfall for the nation's railroads, which then can be "recouped" from captive rail shippers. This is the only logical answer to the agency's cavalier

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nue adequacy regulations. Staggers Act § 205, *codified in pertinent part* at 49 U.S.C. § 10704(a)(2). None of these provisions provides any support whatsoever for the ICC's actions in *Ex Parte No. 393*.

Respondents, citing isolated passages from the legislative history of the Staggers Act, argue that Congress rejected the ICC's pre-Staggers Act interpretation of Section 10704(a)(2) and legislated a "strengthened mandate." (Railroads' Brief at 5). The fact of the matter is that Congress did not change the definition of carrier revenue adequacy. Moreover, any doubt as to the intent of Congress in this regard was clarified by Congressman Eckhardt, a member of the Conference Committee on the Staggers Act, who stated for the record:

> [A]ny suggestion that the conferees intended that the Commission must change its [revenue adequacy] standards from what they are today . . . is unfounded. Clearly, there is nothing in the conference bill or report expressing such a purpose or intent.

126 Cong. Rec. E-4857 (Oct. 15, 1980).

treatment of the three key issues concerning its rate base/rate of return methodology. Respondents' arguments in support of the Court of Appeals' affirmance of the ICC's resolution of these issues do not support a different conclusion.

1. Respondents defend the ICC's decision not to exclude unused and nonuseful assets from carrier rate bases on grounds that such assets are "insubstantial." Yet the carriers' own evidence, which evaluated but one small portion of the carriers' rate base, found, as Respondents concede, "$225 million in unused and unuseful property." (Federal Respondents' Brief at 16). Respondents' claims that the ICC will "eliminate unused and unuseful assets from the investment base" (*id.*) ring hollow when the agency refuses to deduct property identified by the industry itself as unused and nonuseful. Nor can self-serving promises made by the Federal Respondents that the ICC will consider the used and useful question in other proceedings "moot" the ICC's error in ignoring the issue in the present case.[4]

2. Respondents argue the ICC correctly ruled that deferred taxes should be included in the carriers' rate bases. Three

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[4] The Federal Respondents refer to the ICC's March 9, 1983 decision Ex Parte No. 393 (Sub No. 1), *Standards for Railroad Revenue Adequacy* (unprinted) as a proceeding wherein the ICC proposes to take another look at the "used and useful" question. There, the ICC states that "it is particularly important to ensure that assets that are not 'used and useful' are not included in the investment base . . . ." *Id.* at 10. Obviously, the ICC's failure to heed this standard was material error in the proceedings below.

Federal Respondents also argue that the ICC had insufficient time in the proceedings below to identify and remove unused and nonuseful assets. (Brief at 16). This is frivolous in light of the fact that the ICC was under no mandate to place sole reliance on the rate base/rate of return standard. At the very least, the ICC had to "eliminate unused and unuseful assets from our calculation" (*Ex Parte No. 393*, 364 I.C.C. at 811 (App. to Cert. Petn. 9b)) *prior* to its use of this standard.

circuits correctly disagree, however, on grounds that deferred taxes constitute revenues contributed by shippers to carriers at no capital cost, and shippers should not be required to pay carriers a return on no-cost capital. *San Antonio, Texas* v. *United States*, 631 F.2d 831, 847 (D.C. Cir., 1980) *("San Antonio"); Iowa Public Service Company* v. *ICC*, 643 F.2d 542, 546-547 (8th Cir., 1981); *Cleveland-Cliffs Iron Co.* v. *ICC*, 664 F.2d 568, 586 (6th Cir., 1981).

Respondents maintain that these cases are distinguishable because the courts, in reaching their holdings on the deferred tax issue, were simply deferring to the Commission's revenue adequacy regulations which, at the time the decisions were issued, did not permit a return on deferred taxes. Respondents misread the precedents. In the first railroad rate case to consider the deferred tax issue, the D.C. Circuit read Section 10704(a)(2) in light of basic principles of public utility ratemaking which require ratemaking authorities to exclude deferred tax accounts from the rate bases of regulated industries. "Otherwise the rate payer . . . would be paying the carriers for earnings on the tax differential even though it was the rate payer who contributed the differential in the first place." (*San Antonio*, 631 F.2d at 847). In *San Antonio*, the D.C. Circuit noted that the ICC's then-current regulations were consistent with this reading of the law. Its deferred tax ruling was rooted in the statute, not in the ICC's implementing regulations. The *San Antonio* holding has been followed by both the Sixth and Eighth Circuits. The conflict between these court holdings and the contrary result reached in the proceedings below by the Third Circuit can only be resolved by review proceedings before this Court.

3. The ICC arbitrarily and capriciously concluded in *Ex Parte No. 393* that all carrier debt costs should be treated as if they were incurred at the current cost of debt, even though substantial portions of current carrier debt was issued in past years at fixed interest rates that are far below present day levels. The effect of this decision is to grossly overstate the interest costs that rail carriers need to cover in order to enjoy "adequate" revenues.

Federal Respondents maintain that this action "was a rational response to the general problem of properly accounting for inflation." (Brief at 19). However, the point is that fixed interest rates are not subject to inflation. If, for example, money was borrowed in 1968 at a fixed interest rate of 6% over a twenty year term, the fact that the 1983 interest rate on new debt has, due to inflation, risen to 12% is irrelevant because the interest rate paid by the carriers on the 1968 debt is still 6%.

Respondent Railroads argue that using actual debt costs in calculating the cost of capital somehow means that rail carrier earnings "may not exceed a level sufficient to cover the embedded cost of debt." (Brief at 13). Petitioners are saying no such thing. The cost of capital contains an equity and debt component. Properly calculating carrier debt costs does not affect the equity component, and the resulting cost of capital (i.e. debt plus equity) necessarily reflects the higher equity capital costs. Moreover, the actual cost of debt, properly calculated, would reflect and weigh the cost of current debt issuances, along with historical debt, in arriving at the actual cost of debt. Treating all debt as currently issued, however, creates interest expenses which were simply not incurred by the rail industry.

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The combined effect of the identified errors in the ICC's rate methodology for the debt and deferred tax issues alone generates, at the very least, a $835,000,000 overstatement of the carriers' annual revenue shortfall. (Petitioners Brief at 21-24).

CONCLUSION

Respondents' arguments that this Court should not issue a writ of certiorari are without merit. For the reasons cited here

and in the Petition, certiorari should be granted and the case set for briefing and oral argument.

Respectfully submitted,

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